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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 29

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ANNIE M. PFEIFFER

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 35) is a memorandum opinion and therefore not officially reported. The opinion of the Circuit Court of Appeals (R. 43) is reported in 88 F. (2d) 3.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 23, 1937 (R. 48). The petition for certiorari was filed on April 15, 1937,

and granted on May 17, 1937. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether a dividend by a corporation in its own preferred stock payable to holders of common, resulting in the alteration of the preexisting proportionate interests of the stockholders in the two classes of stock, constitutes taxable income to the taxpayer under Section 115 of the Revenue Act of 1928.

2. Whether the question of the cost basis of stock sold during the taxable year that had previously been issued as a stock dividend was in fact raised before the Board of Tax Appeals and should have been considered by the lower court.

3. Assuming that the stock dividend in question does not constitute taxable income at the time of its receipt, what is the correct cost basis of the dividend stock?

4. In the event that this Court should hold that the stock dividend in question was not taxable at the time of its receipt and that the cost basis of the stock sold during the taxable year and previously issued as a stock dividend under the circumstances of this case is not zero, whether the case should be remanded to the Board of Tax Appeals to determine whether the redemption of the stock during the taxable year that had previously been issued as a stock dividend was essentially equivalent to the

distribution of a taxable dividend under Section 115 (g) of the Revenue Act of 1928.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra*, pp. 21–23.

STATEMENT

The facts, as stipulated (R. 9–31) and as found by the Board of Tax Appeals (R. 35–36), are substantially as follows:

The William R. Warner Corporation, hereinafter called the Corporation, was organized in 1920 under the laws of Delaware, its stock at all times consisting of common and preferred. Each class of stock had a par value of $100 per share, but they were otherwise essentially different (R. 35). Dividends upon the preferred stock were never in default (R. 36).

The authorized capital of the corporation was increased several times by the capitalization of earnings. In 1928 the preferred stock was increased from $5,000,000 to $15,000,000, the common stock remaining at $10,000,000, par value. On December 31, 1928, the corporation distributed $5,000,000 par value of preferred stock *pro rata* to common shareholders, and on April 27, 1931, it distributed $2,500,000 shares in a like manner. Each share of preferred had a fair market value of $100 at the date distributed (R. 35). Taxpayer received 12,582 shares in the 1928 distribution and 6,291¼ shares in the 1931 distribution. There was no ac-

cumulation of unpaid dividends on the preferred stock on April 27, 1931. On December 29, 1931, the corporation redeemed with cash at par 8,500 shares of preferred stock, including 2,000 shares belonging to the taxpayer which she had received in the 1928 distribution (R. 36).

In her 1931 return taxpayer reported a capital gain of $180,100 as resulting from the redemption of the 2,000 shares, deducting a basis computed for stock received as a stock dividend. The Commissioner, in determining the deficiency, eliminated the capital gain and included as dividends $200,000 representing the redemption of 2,000 shares of the 1928 dividend and $629,125 representing the 1931 dividend in preferred stock (R. 36).

The Board of Tax Appeals held that the 1931 stock dividend was subject to tax at the time of its receipt under Section 115 of the Revenue Act of 1928. With respect to the redemption of 2,000 shares of stock in 1931, the Board held that since the stock was subject to tax as a dividend in 1928 when it was received by the taxpayer, the redemption in 1931 was not essentially equivalent to the distribution of a taxable dividend within the meaning of Section 115 (g). The Board also held that the 2,000 shares of the 1928 dividend stock sold in 1931 had a cost basis to the taxpayer of $100 each, and consequently that those shares were redeemed without gain or loss to the taxpayer at $100 each in 1931 (R. 36).

On appeal to the court below taxpayer contended that the stock dividend declared in 1931 was not subject to tax under Section 115 (f) of the Revenue Act of 1928. The Government contended that the stock dividend in question was not within the scope of the term "stock dividend" in Section 115 (f) and therefore was subject to the income tax. In the alternative, it contended that at least $200,000 should be added to the taxpayer's income for 1931 on account of the redemption in that year of stock received by the taxpayer as a dividend in 1928. The Government did not ask the lower court to increase the deficiency found by the Board, but merely to uphold the deficiency *pro tanto*. The Government made an additional alternative argument, in the event that the court should reject the above-mentioned alternatives, that the redemption of the preferred stock during the taxable year was essentially equivalent to the distribution of a taxable dividend under Section 115 (g).

The court below held that the 1931 dividend in question was not subject to tax under the terms of Section 115 (f) of the Revenue Act of 1928 and refused to pass upon the question of the cost basis of the stock sold during the taxable year and previously issued as a stock dividend in 1928, on the ground that it was not raised before the Board nor decided by the Board. The court further refused to remand the case to the Board of Tax Appeals for a determination in regard to the application of Section 115 (g) to the circumstances of this case.

Judge Learned Hand dissented in an opinion holding that a stock dividend representing income under the Constitution was subject to tax at the time it was received under Section 115 (f). (R. 43–48.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the stock dividend in question was not subject to tax at the time of its receipt under Section 115 (f) of the Revenue Act of 1928 although it represented income under the Sixteenth Amendment.

2. In failing to hold that Section 115 (f) applies only to stock dividends that do not constitute income under the Sixteenth Amendment.

3. In refusing to pass upon the question of the cost basis of the dividend stock sold during the taxable year.

4. In holding that the question of the cost basis of the dividend stock sold during the taxable year was not raised before the Board of Tax Appeals.

5. In failing to hold that the cost basis of stock previously issued as a dividend, which might have been taxed as income under the Sixteenth Amendment at the time of receipt, is nothing because it cost the taxpayer nothing.

6. In refusing to remand the case to the Board of Tax Appeals for a determination with respect to the application of Section 115 (g) to the circumstances of this case.

7. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

1. The dividend in preferred stock paid upon the common stock held by respondent constituted income to respondent within the meaning of the Sixteenth Amendment as settled by this Court in *Koshland* v. *Helvering,* 298 U. S. 441. Such dividend was not exempt under Section 115 (f) of the Revenue Act, which provides that a stock dividend shall not be subject to tax.

2. Since a question of the cost basis of the dividend stock sold during the taxable year was in fact raised before the Board of Tax Appeals, and was advanced in this form in the court below only to sustain a part of the Board's determination, it should have been considered by the lower court.

3. If this Court should decide that the stock dividend which the taxpayer received in 1931 was not taxable at the time of its receipt, we submit as an alternative argument that when the taxpayer sold 2,000 shares of preferred stock in 1931 which she had received as a dividend in 1928, the entire proceeds of the sale represented taxable gain, since the cost basis is zero.

4. If this Court should decide that the stock dividend was not taxable at the time of its receipt and that the cost basis of the dividend stock is not zero, we submit that the case should be remanded to the Board of Tax Appeals to determine whether the redemption of the preferred stock in 1931, previously issued as a dividend in 1928, was made at such

time and in such manner as to be essentially equivalent to the distribution of a taxable dividend under Section 115 (g) of the Revenue Act of 1928. Since the Board's decision that the section was inapplicable was based upon the express assumption that the stock dividend was taxable at the time of its receipt, and the lower court reversed the Board and held that the stock dividend was not taxable at the time of its receipt, the lower court's action in refusing to remand the case was error.

ARGUMENT

I

A DIVIDEND BY A CORPORATION IN ITS OWN PREFERRED STOCK PAYABLE TO HOLDERS OF COMMON CONSTITUTES TAXABLE INCOME TO THE TAXPAYER UNDER SECTION 115 OF THE REVENUE ACT OF 1928

1. The petitioner's brief in *Helvering* v. *Gowran,* No. 27, October Term, 1937, develops, at pp. 10–11, our view that the decision of *Koshland* v. *Helvering,* 298 U. S. 441, establishes that the payment of a dividend in stock different from that on which it was declared constitutes the receipt of income under the Sixteenth Amendment, at least when the proportionate interest of the stockholder in the corporation is changed in nature or in amount. It is clear that this conclusion is applicable here, and that the stock dividends received by the respondent were income under the Sixteenth Amendment.

The common stock held by respondent prior to the 1931 dividend was voting stock of $100 par value. No dividends could be paid thereon until all dividends, present and in arrears, had been paid on preferred. In liquidation, distributions on the common were subject to prior payment of the par value of the preferred plus unpaid dividends accrued. On the other hand, the $100 par value preferred stock received by respondent as a dividend was redeemable at $105 plus unpaid dividends accrued, was non-voting, and was entitled to a cumulative dividend of six percent and prior payment on liquidation (R. 17–18, 35).

Just prior to the 1931 dividend, the corporation's outstanding stock amounted to 100,000 common shares of which respondent held 25,165 shares, and 79,540 preferred shares of which respondent held 9,642 shares.[1] The total dividend received by common stockholders consisted of 25,000 shares of preferred, of which respondent received 6,291 shares.[2] Thus respondent before the dividend held her common stock subject to asset preferences of 79,540 shares of preferred, totalling $7,954,000, and an annual preferred dividend charge of $477,240, but after the dividend held her shares of common stock

[1] The common and preferred stockholders were substantially different groups. Despite preferred stock dividends paid on common in 1925, 1926, and 1928 (R. 13–14), the common stockholders prior to the dividend in 1931 owned only approximately half of the preferred outstanding (R. 15).

[2] Fractions are omitted in this discussion.

subject to asset preferences of 104,540 shares of preferred, totalling $10,454,000, and an annual preferred dividend charge of $627,240. Cf. *Marr* v. *United States,* 268 U. S. 536, 541. Moreover, in addition to the change in the nature of the proportional interest in the net assets and income of the corporation represented by the common shares, respondent's proportional interest in the equities in net assets and income attributable to preferred was materially altered. Before the dividend, respondent's 9,642 shares of preferred constituted 12 percent of the outstanding preferred, and gave respondent an interest in net assets of $964,200 and an annual cumulative right to $57,852 in dividends subject to no priorities. But after the dividend, respondent held 15,933 shares of preferred stock which constituted 15 percent of the preferred outstanding after the dividend, and which gave respondent an interest in net assets of $1,593,300 and an annual cumulative right to $95,598 in dividends subject to no priorities. So, too, as a result of the dividend the proportional interests of the common and preferred stockholder groups were materially altered. Whereas before the dividend common stockholders owned but fifty-one percent of the preferred stock, and the equities in assets and income attributable thereto, after the dividend the common stockholders owned sixty-two percent of the stock and equities. The preferred stock dividend received by the respondent was thus income within

the meaning of the Sixteenth Amendment as settled by the *Koshland* decision.

2. The question becomes one of whether the dividend received by respondent, which clearly constituted income within the meaning of the Sixteenth Amendment, was taxed by Congress at the time of its receipt or was exempt within the meaning of Section 115 (f) of the Revenue Act of 1928. The Government's argument on this point is set forth in full at pp. 14–24 of our brief in *Helvering* v. *Gowran,* No. 21, October Term, 1937, to which the Court is respectfully referred.

II

THE QUESTION OF THE COST BASIS OF THE DIVIDEND STOCK SOLD DURING THE TAXABLE YEAR SHOULD HAVE BEEN CONSIDERED BY THE LOWER COURT

The court below refused to consider the argument of the Government that, if the 1931 dividends were not taxable as ordinary income, then the cost basis on the 1931 sale of preferred stock received as a dividend in 1928 was zero. This was because the court was of the view that the question had not been raised before the Board (R. 46). Before discussing the question on the merits, we shall show that the question was in fact raised before the Board and should have been considered by the court below.

The deficiency notice which the Commissioner sent the taxpayer in December 1935, and which

was attached to the petition filed in the Board of Tax Appeals, contains a statement showing adjustments to net income. Schedule 1 shows under the heading of "Unallowable deductions and additional income" an item of "Preferred stock redeemed" in the amount of $200,000, and another representing "Dividend in preferred stock" in the amount of $629,125, giving a total of $829,125. From this sum is deducted under the heading of "Nontaxable income and additional deductions" an item of "Capital gain" in the amount of $180,100 (R. 6–7).

Paragraph (j) of the Petition for Review alleges that the taxpayer included in her return for the year 1931 the sum of $180,100 as capital gain from the sale of 2,000 shares of preferred stock sold to the Warner Corporation during the year 1931, and that she paid a capital gain tax thereon in the amount of $22,512.50. The taxpayer expressly petitioned the Board of Tax Appeals to relieve her from the deficiency in tax resulting from treating the proceeds of the sale of 2,000 shares of preferred stock received by her in the year 1928 as a taxable dividend for the year 1931; and in the event that a deficiency in tax should be found by reason of treating the 6,291¼ shares of preferred stock as a taxable dividend, that the amount of the deficiency should be reduced by the elimination of the capital gain tax on the 2,000 shares of preferred stock sold to the Warner Corporation in the year 1931 (R. 5).

The Board of Tax Appeals found that the taxpayer reported in her 1931 return a capital gain of $180,100 as resulting from the redemption of the 2,000 shares after deducting a basis computed for stock received as a stock dividend. The Board also found that the Commissioner, in determining the deficiency, eliminated the capital gain and included as dividends $200,000 representing the redemption (R. 36). In its opinion the Board said (R. 36):

> The Commissioner held that the redemption of the 2,000 shares in 1931 was at such time and in such manner as to be substantially equivalent to a taxable dividend in 1931, within the meaning of section 115 (g) of the Revenue Act of 1928. He erred in this since the distribution was subject to tax as a dividend in 1928 (see cases above cited). Thereafter the shares had a basis for gain or loss to the petitioner of $100 each, and they were redeemed without gain or loss to the petitioner at $100 each in 1931.

Hence the question of the cost basis of the 2,000 shares of stock redeemed in 1931 was clearly in issue before the Board of Tax Appeals, and was passed upon by the Board, which determined a different basis from that adopted by the taxpayer.

Furthermore, taxpayer's return with respect to the 1931 stock dividend and the capital gain on the redemption of the 1928 dividend stock purported to follow Treasury Regulations in effect at the time. The deficiency notice was issued after

the case of *Tillotson Manufacturing Co.* v. *Commissioner,* 27 B. T. A. 913, affirmed 76 F. (2d) 189 (C. C. A. 6th), cast substantial doubt upon the validity of the Treasury Regulations. (This doubt was confirmed in the decision of this Court in the *Koshland* case.) Accordingly, the Commissioner sought to tax the 1931 stock dividend as income when received. Having succeeded upon that point before the Board, the Commissioner could no longer maintain that the substantially similar 1928 stock dividend was taxable upon redemption under Section 115 (g) because that dividend, like the 1931 dividend, was not within the exemption of Section 115 (f) and was taxable at the time of its receipt. The Board then reasoned that since the 1928 dividend was not exempt from tax at the time of receipt, its basis upon redemption would be $100 per share. It is apparent that at all times in this proceeding the questions of exemption of dividend shares and their cost basis have been interrelated and each was inherent in the appeal. The two questions of exemption and basis have always been tied together in the Treasury Regulations since the decision of this Court in *Eisner* v. *Macomber,* 252 U. S. 189, and the provision of the Revenue Act of 1921 to the effect that a stock dividend shall not be subject to tax. See *Miles* v. *Safe Deposit Co.,* 259 U. S. 247, and the dissenting opinion of Judge Learned Hand in the instant case (R. 47–48).

The situation is that the Board has determined a deficiency against the taxpayer of $89,841.75 (R. 37) and in so doing has considered the question of the basis for capital gains. In this case, as in *Helvering* v. *Gowran,* No. 27, October Term, 1937 (see Brief for Petitioner, pp. 28–29), there was no occasion for the Commissioner to urge an alternative theory before the Board which would sustain only a part of this deficiency.[3] There was no occasion for him to take a cross-appeal, since his alternative theory was incompatible with the Board's determination that the 1931 dividend was taxable income, and would result in a smaller deficiency. A party must show injury before he can appeal from a decision.

The issue before the court below was the correctness of the deficiency entered by the Board. The Commissioner did not complain of the decision of the Board. He sought only to urge in partial support of its determination a theory which could be advanced only if the Board were held erroneously to have accepted the Commissioner's main argument. In this case, as in *Helvering* v. *Gow-*

[3] The corporation in 1931 redeemed 2,000 shares distributed to the taxpayer in 1928 (R. 36). A tax on capital gains thus realized would plainly be much less than the incompatible tax on income represented by the further dividend of 6,291¼ shares received by the taxpayer in 1931 (R. 36).

ran, there is involved only a question of law; there is no relevant question of fact which has not been found by the Board. Similarly, there is no element of surprise or injustice to the party seeking review by the Circuit Court of Appeals. There is no attempt to secure a reversal of the Board on an issue not presented to it. Compare *General Utilities Co.* v. *Helvering,* 296 U. S. 200; *Helvering* v. *Salvage,* 297 U. S. 106. This case seems well within the rule which allows the respondent to advance any argument in support of the judgment below. *United States* v. *American Express Ry. Co.,* 265 U. S. 425, 435–436; *Langnes* v. *Green,* 282 U. S. 531, 538–539; *Stelos Co.* v. *Hosiery Corp.,* 295 U. S. 237, 239.

Accordingly, we submit that the court below should have considered the issue as to the proper cost basis of the 1928 preferred stock upon its redemption in 1931.

III

ASSUMING THAT THE STOCK DIVIDEND IN THIS CASE DOES NOT CONSTITUTE TAXABLE INCOME AT THE TIME OF ITS RECEIPT, THE CORRECT COST BASIS OF SUCH STOCK IS ZERO

If this Court should decide that the dividend in preferred stock was not taxable at the time of its receipt in April 1931, we submit that at least $200,000 should be added to the taxpayer's income for

1931 on account of the redemption in that year of stock received as a dividend in 1928.

Here the 1928 preferred stock dividend, just as the not essentially different 1931 dividend, constituted income to respondent within the meaning of the Sixteenth Amendment. See pp. 8–11, *supra*. But if such dividend stock, in the opinion of this Court, was nevertheless exempt from tax under Section 115 (f), then the proper basis for such stock is cost, and the cost here is zero. This point is fully argued at pp. 25–27 of our brief in *Helvering* v. *Gowran,* No. 27, October Term, 1937, to which the Court is respectfully referred.

IV

IF THIS COURT SHOULD DECIDE POINTS I, AND EITHER II OR III ADVERSELY TO THE GOVERNMENT, THE CASE SHOULD BE REMANDED TO THE BOARD OF TAX APPEALS TO DETERMINE THE APPLICATION OF SECTION 115 (g) TO THE CIRCUMSTANCES OF THIS CASE

If this Court should decide against the petitioner on Point I, and on either of Points II or III, we submit that the case should be remanded to the Board of Tax Appeals to determine whether redemption of the preferred stock was made at such time and in such manner as to be essentially equivalent to the distribution of a taxable dividend under Section 115 (g) of the Revenue Act of 1928, *infra,* p. 22. In the year 1931 the corporation in

this case redeemed 2,000 shares of preferred stock belonging to the taxpayer which had been issued as a stock dividend in the year 1928. Section 115 (g) of the Revenue Act of 1928, *infra,* p. 22, provides that if a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question to be decided under Section 115 (g) is essentially one of fact dependent upon the circumstances in each case. *Commissioner* v. *Babson,* 70 F. (2d) 304 (C. C. A. 7th), certiorari denied, 293 U. S. 571; *Hyman* v. *Helvering,* 71 F. (2d) 342 (App. D. C.), certiorari denied, 293 U. S. 570; *Randolph* v. *Commissioner,* 76 F. (2d) 472, 476 (C. C. A. 8th), certiorari denied, 296 U. S. 599; *McGuire* v. *Commissioner,* 84 F. (2d) 431 (C. C. A. 7th), certiorari denied, 299 U. S. 591. It was probably for this reason that the lower court refused to disturb the opinion of the Board as indicated by its citation of *Helvering* v. *Rankin,* 295 U. S. 123. But the Board of Tax Appeals expressly based its conclusion that the redemption of the 2,000 shares in 1931 was not essentially equivalent

to a dividend under Section 115 (g) upon the ground that the distribution of the stock dividend was subject to tax as a dividend in 1928 (R. 36). Since the lower court reversed the Board's decision and held that the stock dividends in question were not subject to tax at the time they were received, the question as to the application of Section 115 (g) to the facts and circumstances of the redemption can be determined only if the case be remanded to the Board. To refuse to do so, as the lower court did,[4] was arbitrary.

CONCLUSION

The lower court erroneously construed the term "stock dividend" in subdivision (f) of Section 115 of the Revenue Act of 1928 to include any stock dividend, whether it represented income under the Constitution or not. If, however, this Court should decide that the stock dividend was not taxable at the time of receipt, the cost basis of the dividend stock is zero. If this Court decides against the petitioner on both of these grounds, the case should be remanded to the Board of Tax

[4] It is possible that the opinion of the court below (R. 46) may be interpreted to mean merely that the court itself would not hold Section 115 (g) applicable without a decision of the Board on the factual questions, and that its mandate of reversal was intended to permit the Board to consider this question on further proceedings. If this be the correct interpretation, which we think unlikely, we have no complaint as to this action of the court below but ask instead that the matter be clarified.

Appeals to pass upon the application of Section 115 (g).

Respectfully submitted.

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OCTOBER 1937.

APPENDIX

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except in section 203 (a) (4) and section 208 (c) (1), relating to insurance companies), means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the basis of the stock provided in section 113.

(c) *Distributions in liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized

only to the extent provided in section 112. In the case of amounts distributed in partial liquidation (other than a distribution within the provisions of section 112 (h) of stock or securities in connection with a reorganization) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits within the meaning of subsection (b) of this section for the purpose of determining the taxability of subsequent distributions by the corporation.

* * * * *

(f) *Stock dividends.*—A stock dividend shall not be subject to tax.

(g) *Redemption of stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend. In the case of the cancellation or redemption of stock not issued as a stock dividend this subsection shall apply only if the cancellation or redemption is made after January 1, 1926.

(h) *Definition of partial liquidation.*—As used in this section, the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

Treasury Regulations 74, relating to the Revenue Act of 1928:

> ART. 628. *Stock dividends.*—The issuance of its own stock by a corporation as a dividend to its shareholders does not result in taxable income to such shareholders, but gain may be derived or loss sustained by the shareholders from the sale of such stock. The amount of gain derived or loss sustained from the sale of such stock, or from the sale of the stock in respect of which it is issued, shall be determined as provided in articles 561 and 600.

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IN THE

Supreme Court of the United States

October Term, 1936

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

v.

ANNIE M. PFEIFFER.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

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IN THE

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October Term, 1936

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v.

ANNIE M. PFEIFFER.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

Opinions Below.

The opinion of the Board of Tax Appeals (R. 67) is a memorandum opinion and therefore not officially reported. The opinion of the Circuit Court of Appeals (R. 85) is reported in 88 Fed. (2d) 3.

Questions Presented.

I. Is a dividend by a corporation in its own Preferred Stock, paid to holders of Common Stock when there were other shares of Preferred Stock of the same classification outstanding a part of which were held by others than the common stockholders, a "stock dividend" within the meaning of Section 115 (f) of the Revenue Act of 1928?

II. Is such a Preferred Stock Dividend taxable under the Sixteenth Amendment to the Constitution?

III. Should the Circuit Court of Appeals have passed upon the question of the cost basis of the Dividend Stock sold during the taxable year?

IV. If the Circuit Court of Appeals should have passed upon the cost basis of the Dividend Stock, what is the correct cost basis, assuming that such dividend was not subject to tax under the Statute at the time of its receipt?

V. Should the Circuit Court of Appeals have held that the proceeds from the redemption of the Dividend Stock were taxable under Section 115 (g)?

Statutes Involved.

The Statutes involved are contained in the Appendix.

Statement.

This controversy arises out of a proposed deficiency in Federal Income Tax of the Responding Taxpayer for the year 1931.

William R. Warner Corporation, hereinafter called the "Corporation", was organized in 1920 under the Laws of Delaware, its stock at all times consisting of Common and non-voting Preferred. Each class of stock had a par value of $100 per share (R. 20). Dividends upon the Preferred Stock were never in default (R. 31). The authorized Capital Stock of the Corporation was increased several times by capitalizing its earnings (R. 22, 24, 26). In 1928, the Corporation was again recapitalized and the authorized Capital Stock was increased *from* $15,000,000, consisting

of $5,000,000 of Preferred Stock and $10,000,000 of Common Stock, *to* $25,000,000, consisting of $15,000,000 of Preferred Stock and $10,000,000 of Common Stock,—an increase of $10,000,000 in the Preferred Stock (R. 27).

In 1928 the Corporation issued and distributed 50,000 shares of the Preferred Stock, so authorized, as a dividend to the Common Stockholders of the Corporation in the ratio of one share of Preferred Stock to each two shares of Common Stock (R. 27, 52).

In 1931 the Corporation issued and distributed 25,000 shares of Preferred Stock of the Corporation to the Common Stockholders as a stock dividend in the ratio of one share of Preferred Stock to each four shares of Common Stock (R. 28, 55). At the time this Stock Dividend was declared, 79,540 shares of Preferred Stock were outstanding, of which 40,727 shares were owned by the Common Stockholders (R. 29). The Taxpayer was the owner of 25,165 shares of Common Stock and 9,642 shares of Preferred Stock and received, as her share of the 1931 distribution, 6,291¼ shares of Preferred Stock of the Corporation (R. 29). The market value of the shares so received was $629,125,—their par value (R. 32).

Throughout these several recapitalizations, including the recapitalizations of 1928 and 1931, the terms, provisions and priorities of the two classes of Stock remained unchanged (R. 27). The earnings of the Corporation itself, as well as the consolidated net earnings of the Corporation and its subsidiaries, were far more than sufficient to pay the dividends on the Preferred Stock of the Corporation at any time outstanding (R. 62). Cash dividends were paid by the Corporation, as called for by its Preferred Stock, and large additional cash dividends were paid on the Common Stock during each of the years 1920 to 1931, inclusive

(R. 62). The earned surplus of the Corporation and its subsidiaries on December 31, 1931, after the payment of the Stock Dividend in dispute, was $8,845,000 (R. 59).

In 1931 the Corporation redeemed with cash at par, 8,500 shares of its Preferred Stock, including 2,000 shares belonging to the Taxpayer, which were a part of the Stock Dividend which she had received in 1928 (R. 32).

In her 1931 Income Tax Return the Taxpayer did not report as income the 6,291¼ shares of Preferred Stock received by her as a Stock Dividend. The Commissioner, in determining the deficiency, included as taxable income the sum of $629,125, representing the value of this Stock Dividend (R. 13).

In her 1931 Income Tax Return the Taxpayer reported a capital gain of $180,100, as having resulted from the redemption of the 2,000 shares of Preferred Stock—a part of the shares issued to her in 1928 as a Stock Dividend—the gain having been determined in accordance with Regulations of the Treasury Department then effective, and paid a tax of $22,512.50 on such capital gain (R. 33).

The Commissioner, in determining the deficiency, eliminated the capital gain of $180,100 and included as a taxable dividend the sum of $200,000 received by the Taxpayer from such redemption (R. 13).

The Board of Tax Appeals held that the dividend paid in Preferred Stock in 1931 was not a "stock dividend" within the meaning of Section 115 (f) of the Revenue Act of 1928, and that, therefore, such dividend was a taxable dividend. With respect to the 2,000 shares of stock issued in 1928 and redeemed in 1931, the Board held that, since in its opinion the Stock Dividend was subject to tax as income when received in 1928, the redemption in 1931 was not essentially equivalent to the distribution of a taxable divi-

dend within the meaning of Section 115 (g). The Board explained that the shares of stock sold in 1931, being, as it held, income in 1928, had a cost basis to the Taxpayer of $100 per share, and consequently that the redemption of those shares in 1931 resulted in no gain to the Taxpayer in 1931 (R. 69).

On appeal by the Taxpayer to the Circuit Court of Appeals the Government contended that the Stock Dividend in question was not a "stock dividend" within the meaning of Section 115 (f) of the Statute and, therefore, was subject to income tax. This was the only issue raised on the appeal, since the Government did not file a cross appeal from the Board's decision on the question involving the application of Section 115 (g). Notwithstanding the Government's failure to file a cross appeal, it made the two following alternative contentions in its brief and oral argument before the Circuit Court of Appeals.

(1) That the Taxpayer realized a capital gain of $200,000 as a result of the redemption of the 2,000 shares of Preferred Stock which she had received as a Stock Dividend in 1928, basing this contention upon the proposition that this Stock Dividend in her hands had a basis of zero. This would result in a capital gain of $200,000 to the Taxpayer instead of $180,100, the amount originally reported by her in her Return. This contention was not made by the Commissioner in his 90-Day Letter or in his Answer to the Petition before the Board and was not urged before the Board nor raised by cross appeal to the Circuit Court of Appeals.

(2) That the redemption in 1931 of a portion of the Preferred Stock Dividend was taxable as the essential equivalent to the distribution of a taxable dividend under Section